



Income Tax DOR Directive 95-6

GOVERNMENT DOCUMENTS
COLLECTION
Massachusetts
Department of
Revenue
JUL 25 1995

Individual Debtor Determination of Taxable Years

University of Massachusetts
Depository Copy

Issue:

May an individual debtor in a Chapter 7 or Chapter 11 bankruptcy case, who must split the taxable year for state income tax purposes in any event, make an election pursuant to § 1398(d) of the Internal Revenue Code to split the federal taxable year in which the bankruptcy case is filed into two taxable years, and file Massachusetts returns that reflect that election?

Directive:

Yes, an individual debtor may file Massachusetts income tax returns in which the taxable year for state income tax purposes is split into two taxable years, reflecting the § 1398(d) election as shown on the debtor's federal returns. However, if an individual debtor does not elect to split the federal taxable year pursuant to § 1398(d), that debtor must still file Massachusetts income tax returns reflecting, for state tax purposes, that the taxable year in which the bankruptcy case is filed is split into two taxable years pursuant to the provisions of the Bankruptcy Code.

Discussion of Law:

Internal Revenue Code

The Internal Revenue Code applies only to federal taxes. Section 1398 of the Internal Revenue Code (26 U.S.C. § 1398) applies to any case under Chapter 7 (liquidations) or Chapter 11 (reorganizations) of Title 11 of the United States Code (the "Bankruptcy Code") in which the debtor is an individual. Under this provision, the debtor may elect to treat the taxable year in which the debtor files a petition for relief as two taxable years, "the first of which ends the day before the commencement date, and the second of which begins on the commencement date." § 1398(d)(2)(A). The commencement date is the day on which the case under Title 11 of the United States Code commences. § 1398(d)(3).

Bankruptcy Code

The Bankruptcy Code (Title 11 of the United States Code) contains special tax provisions applicable to "any State or local law imposing a tax on or measured by income..." 11 U.S.C. §§ 728(a); 1146(a). For the purposes of these sections, "[t]he taxable period of a debtor that is an individual shall terminate on the date of the order for relief under this chapter, unless the case was converted [under other sections] of this title." *Id.* The date of the "order for relief" is usually the date the bankruptcy petition is filed with the bankruptcy court. See 11 U.S.C. §§ 301; 303; see also Federal Rules of Bankruptcy Procedure 1013 and 1011.

Under the provisions of the Bankruptcy Code, then, the determination of taxable years for state income taxes requires that the taxable year of an individual debtor be split such that the first taxable year will usually end on the date when the bankruptcy petition is filed, and the second taxable year will usually begin the day after the bankruptcy petition is filed.

Interplay Between the Two Codes

The taxable years for state income taxes under the Bankruptcy Code do not correspond precisely with those of the Internal Rev-

enue Code. Because of this discrepancy, a taxpayer is potentially responsible for filing state income tax returns which reflect taxable periods different from the federal taxable periods in the year in which the bankruptcy case is filed.

That Congress did not intend such an unwieldy result in the case of a taxpayer who makes the § 1398(d) election is amply demonstrated by the legislative history of the Bankruptcy Reform Act, where the intent was to minimize discrepancies between the Internal Revenue Code and the Bankruptcy Code by making "tax considerations as nearly neutral as possible in determining whether or not a taxpayer should file a bankruptcy petition." See *6 Norton Bankruptcy Law and Practice* 2d, § 128.1.

To implement this neutrality, bankruptcy provisions in the Reform Act were drafted "entirely in terms of federal income tax concepts." *Norton, supra*. In addition, the special state and local tax provisions of the Bankruptcy Code were slated to be deleted due to the lack of complementary provisions applicable to federal taxes; that they were included in the final version of the Reform Act appears to have been an oversight. *Id.* (See *United States v. Ron Pair Enterprises, Inc.*, 109 S.Ct. 1026, 489 U.S. 235, L. Ed. 2d 290 (1989), *rev'g* 828 F.2d 367 (6th Cir.1987) ("The plain meaning of legislation should be conclusive except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.' *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, S.Ct. 3245, 3250, 73 L.Ed.2d 973 (1982). In such cases, the intention of the drafters, rather than the strict language, controls. *Ibid.*") *Id.* at 1031.)

Conclusion:

If an individual debtor makes a § 1398(d) election on his or her federal return, the debtor's Massachusetts return may reflect that election. In this situation, for state income tax purposes the first taxable year will end (as will the first federal taxable year) *on the day before* the bankruptcy case commences, and the second taxable year will begin (as will the second federal taxable year) *on the day the bankruptcy case commences*.

If an individual debtor does not make a § 1398(d) election on his or her federal return, the debtor must still split the taxable year in which the bankruptcy case is filed into two taxable years, for Massachusetts income tax purposes, pursuant to the provisions of the Bankruptcy Code. In this situation, for state income tax purposes the first taxable year will usually end *on the day the bankruptcy case commences*, and the second taxable year will usually begin *the day after* the bankruptcy case commences.

Mitchell Adams
Commissioner of Revenue
May 9, 1995